

You Can Short A Dull Market

Another Time-Worn Wall Street Cliché Bites The Dust

At what point in human development did we build a sufficient storehouse of shibboleths, clichés, aphorisms, bon mots and platitudes? I am going to guess it was somewhere around the mastery of fire: “If it’s hot / grab it not!” Wall Street would be lost without them; how, exactly, do we go about climbing a wall of worry, anyway?

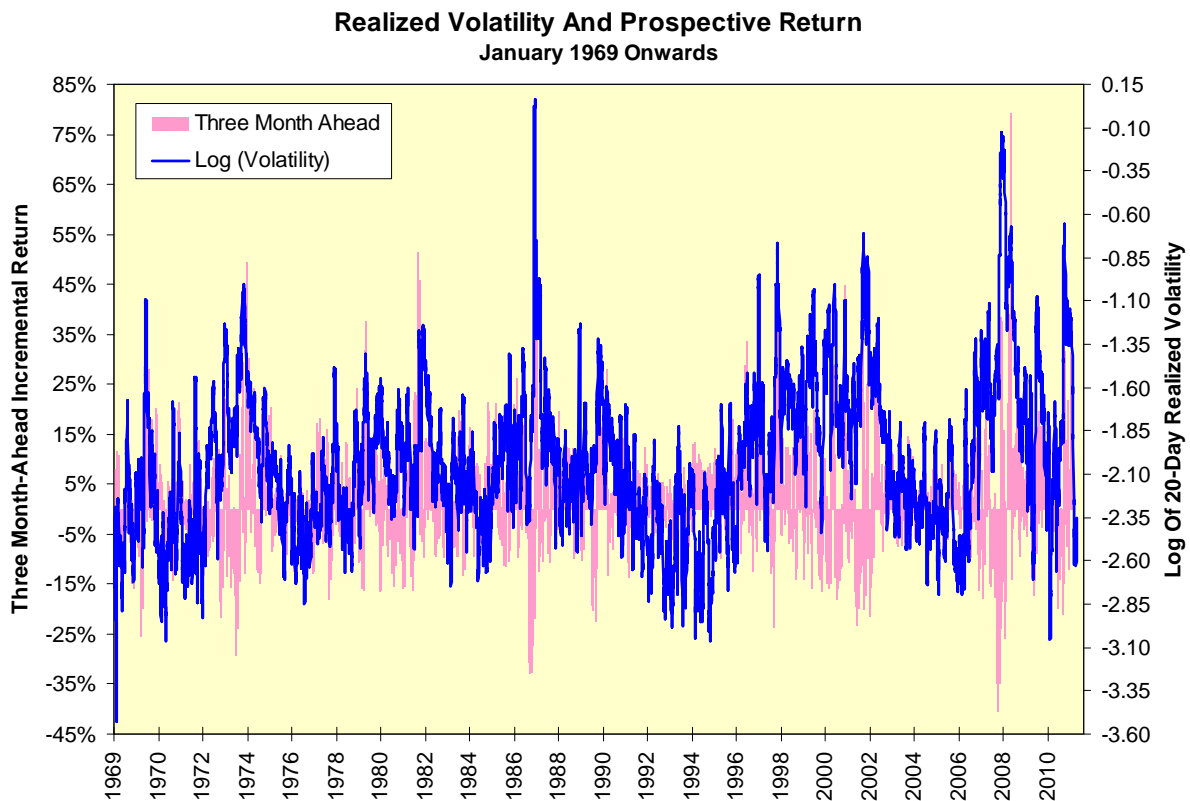
One of my favorites is, “Never sell a dull market.” First, you need a dull market, and that is nothing more than a state of mind. I cannot define it as a given range or trend-channel in a major average such as the S&P 500 (SPY) or NASDAQ 100 (QQQ). Is it a pennant consolidation, a base-building bottom, or some other charting pattern? It is what you think it is, nothing more and nothing less.

Realized Volatility and Prospective Return

The issue came to mind early last week when a reporter called and asked whether realized volatility had any predictive capacity for future returns? Realized volatility is backward-looking and unlike the implied volatility involved with option markets, contains no insurance component. I might add I am unaware of Wall Street wisdom such as the VIX being over 30 constituting a buy signal; how did that work for people during the 2008-2009 timeframe?

To test this, I decided to use Bloomberg’s calculation of 20-day realized volatility for the S&P 500 index as a base and then look at the incremental return for periods five days, ten days, one-, three- and six months ahead and one year-ahead against that 20-day base period. If, for example, the market’s return for the 20-day volatility calculation period was 2% and the next three-months’ return was 10%, then my incremental return would be $[1.1/1.02] - 1$, or 7.84%. I ran these calculations back to January 1969.

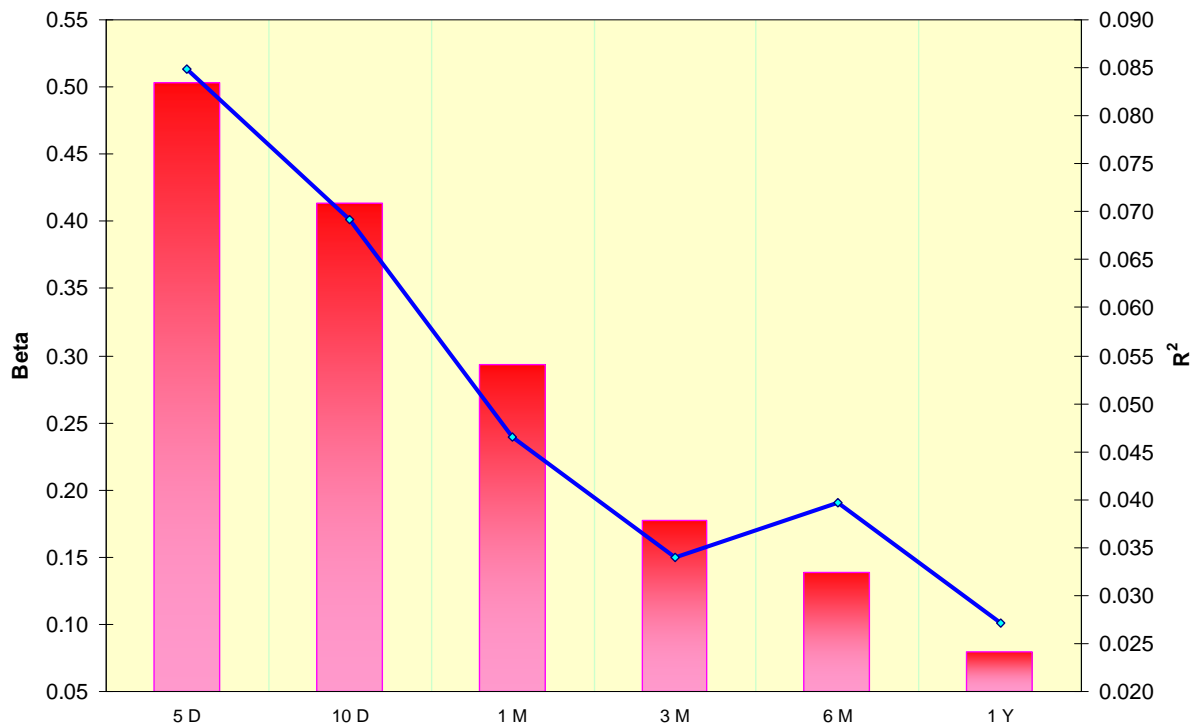
The data did confirm we had been in a low realized-volatility period. While it is hard to confirm visually from a chart below, an analysis of prospective incremental returns as a function of realized volatility indicated a positive relationship.



A consolidation of the relationship over the period tested is very clear. Here the regression betas are fairly sizeable and statistically significant. They decline over time; realized volatility is a much better predictor of short-term

incremental return than long-term incremental return. However, the r^2 of the relationships, the percentages of variance explained, are not significant at all.

Prospective Incremental Return As A Function Of Realized Volatility



What can be concluded here? Quite simply, high realized volatility does precede positive incremental returns and vice-versa, but while these are factors are significant, they are anything but major contributory factors in explaining returns. It is sort of like wearing a nice suit to an interview; it will help, but it will not get you the job.

But the real kicker is low realized volatility leads low or negative incremental returns. So step right up and short that dull market: You have both the data and my best wishes at your side.